

TEACHERS' RETIREMENT BOARD

INVESTMENT COMMITTEE

Subject: Credit Enhancement Program- Item Number: 8
K-12 Schools and Community Colleges

Attachment(s): 1

Action: _____ Date of Meeting: November 8, 2000

Information: X Presenters: Richard Rose

EXECUTIVE SUMMARY

One of the objectives for the Investment Branch is to “Expand the underwriting of credit enhancement transactions that support California K-12 Schools and California Community Colleges.” This agenda item provides a brief historical account of the CalSTRS Credit Enhancement Program, summarizes activities designed to serve California Schools and other employing agencies, documents the volume of school bonds issued in 1999 in a variable rate mode, and discusses the possibility of CalSTRS providing credit enhancement in support of teacher housing in high cost areas of California.

In 1994, the CalSTRS Credit Enhancement Program (CEP) commenced providing credit enhancement and liquidity support for municipal capital market transactions utilizing variable rate bonds and commercial paper. SB 2126 was passed in 1998, which permitted CalSTRS to provide credit enhancement to employing agencies. Since that time, CalSTRS has provided over \$230 million in liquidity arrangements supporting the California Housing and Finance Agency (CHAFA). School financings have been fewer, limited to \$18.3 million to the Kern High School District, primarily due to the limited number of Certificates of Participations (COPs) issued in a variable rate mode. Variable rate COPs are the primary bond product that is suitable for the CEP.

The CalSTRS staff has been working on project financings closely related to Community College and K-12 school financings. Staff is currently working with the Ecumenical Association for Housing (EAH) and George K. Baum & Co. on developing teacher housing in California. EAH is a developer of affordable housing and is based in San Rafael, CA. George K. Baum is an investment-banking firm that has substantial experience in multi-family housing finance. EAH is expected to receive such a mandate to develop teacher housing in San Jose. EAH, George K. Baum & Co., and CalSTRS staff would like to further develop this market. At the current time, the size of the market and the number of opportunities are unknown.

INTRODUCTION

One of the objectives for the Investment Branch is to “Expand the underwriting of credit enhancement transactions that support California K-12 Schools and California Community Colleges.” This agenda item provides a brief historical account of the CalSTRS Credit Enhancement Program (CEP), summarizes activities designed to serve California schools and other employing agencies, documents the volume of school bonds issued in 1999 in a variable rate mode, and discusses the possibility of CalSTRS providing credit enhancement in support of teacher housing in high cost areas of California.

In the early 1990s, CalSTRS staff conducted research on the feasibility of generating fee income by assisting construction finance efforts for California public schools. Due to limitations in the California Education Code, it was concluded that California public schools could not be serviced, however, it was determined that CalSTRS could generate fee income by providing a credit enhancement for public and private activity bonds in the State of California.

After staff obtained credit ratings from both Moody’s Investor Services and Standard and Poor’s, CalSTRS first credit enhancement transaction was made in 1994 when it participated in a liquidity facility to support the commercial paper program for the Port of Long Beach (“Port”). CalSTRS’ original commitment to support the Port was for \$25 million, and has subsequently grown to \$87.5 million. Since that first transaction in 1994, the CEP has grown to over \$1 billion in total commitments.

The CalSTRS CEP provides liquidity and credit enhancement to public and private activity bonds supporting municipalities, education, industrial development, pollution control, housing and other sectors supporting the public good in California and contiguous states. The CalSTRS credit enhancement product primarily supports variable rate debt that is typically structured as a long-term bond that is remarketed on a weekly basis. This is the same market that is served by commercial banks. CalSTRS supports these financial institutions by confirming or “wrapping” those financial institutions that need support in the capital markets, or by participating in the larger transactions so that the originating financial institution can diversify its credit exposure.

The variable rate component of the bond market is actually small. The vast majority of bonds are issued in fixed rate mode either based on the strength of the underlying credit or else backed by bond insurance.

CalSTRS does not act as a bond insurer, which is actually a different segment of the credit enhancement industry. Where CalSTRS collects fees on a quarterly basis for ongoing commitments, which are typically 7 years and less, bond insurers get one upfront fee on a transaction that may have a maturity of 20-30 years. Bond insurers then invest these one-time fees in the capital markets and accrue the income during the term of the bond. Bond insurance has different economics and accounting requirements than the quarterly fee income method that CalSTRS utilizes.

EDUCATION AND OTHER EMPLOYER FINANCING HISTORY

Some credit enhancement opportunities were lost in the early years of the program due to limitations in the California Education Code, which restricted CalSTRS from conducting business transactions, which “inure to the benefit of a school district or other employing agency.” This limitation was altered in the fall of 1998 with the passage of SB 2126 which permitted CalSTRS to provide credit enhancement to employing agencies, subject to meeting fiduciary standards. CalSTRS continues to operate under Section 503 of the Internal Revenue Code, which is aimed at ensuring transactions with employing agencies are conducted at “arms-length”. Section 503 has a safe harbor provision, which provides that in a transaction between a pension fund and employing agency, if the pension fund represents no more than 25% of the transaction, it will not have to meet any more tests as to acceptability under the regulation.

In order to operate under the IRS safe harbor provision, the Credit Enhancement Policy limits the amount of each transaction involving employing agencies such as California public schools, public colleges and universities, or California agencies and departments to 25% of the total commitment.

Since the passage of SB 2126, CalSTRS has successfully provided \$230 million in credit enhancement to the California Housing and Finance Agency (CHFA) supporting California single family and multiple family housing. CalSTRS has also provided \$18.5 million in credit enhancement supporting the Kern High School District.

Other opportunities have come to CalSTRS but did not come to fruition for a variety of reasons. Some transactions are small and cannot be carved up to provide CalSTRS with a 25% share. Due to their small size, these transactions require from 50% to 100% participation by CalSTRS. Staff spent significant time working on the SMART bond program with the Treasurer’s Office. \$48 million in short term debt instruments were issued as bridge financing until Prop 1A funds could be received in the summer of 2000. Upon final analysis, it was determined that credit enhancement by CalSTRS and others would not be needed. Staff spent several months working on a \$100 million transaction for a large school district in Southern California. In the end, the district elected to issue the bonds in a fixed rate mode.

MARKET ANALYSIS FOR K-12 AND COMMUNITY COLLEGES

Data in the following chart represents the amount and type of debt issued in FY 1999 by California Community Colleges and California K-12 Schools. Both community colleges and K-12 School Districts issued more tax and revenue anticipation notes (TRANs) in 1999 than any other debt type. TRANs serve as bridge financing for schools until tax revenues arrive on a quarterly basis. General Obligation (GO) bonds are debt issued based on the support of the local property taxpayers. GO bonds are almost always fixed rate bonds. As previously

mentioned, COPs lend themselves well to the CalSTRS CEP. COPs are frequently issued as variable rate debt, but are also issued as fixed rate debt. COPs represent debt issued by districts where the debt repayment comes from the operating funds. COPs are normally used when communities cannot find the voter support for GO bonds. Due to the strong economy in California in recent years, many local communities have found voter support for GO bonds and have not needed to issue COPs.

As the following chart indicates, Community Colleges issued only \$75.7 million in COPs in 1999, and none of that was variable rate debt, which is CalSTRS prime credit enhancement product. K-12 schools issued \$518 million in COPs in 1999 and \$127.6 million was represented by variable rate debt. Other financial institutions provided the credit enhancement for these transactions and CalSTRS was not offered an opportunity to support the transactions.

California Community Colleges-1999 Debt Issues

Debt Type	Amount	%	Variable Rate Debt	
			Amount	%
Tax and Revenue Anticipation Notes (TRANS)	\$301,650,000	72.10%	\$0	0%
Certificates of Participation (COP)	\$75,700,000	18.09%	\$0	0%
General Obligations (GO)	\$27,000,000	6.45%	\$0	0%
Other Debt (Revenue Bonds)	\$14,035,000	3.36%	\$0	0%
TOTAL DEBT	\$418,385,000	100.00%	\$0	0%

Source: California Debt & Investment Advisory Commission (CDIAC)

California K-12 Schools-1999 Debt Issues

Debt Type	Amount	%	Variable Rate Debt	
			Amount	%
Tax and Revenue Anticipation Notes (TRANS)	\$2,209,635,000	45.34%	\$0	0%
General Obligations (GOs)	\$1,802,703,020	36.99%	\$0	0%
Certificates of Participation (COPs)	\$518,194,992	10.63%	\$127,640,000	2.62%
Other Debt (Tax Obligation & Revenue Bonds)	\$335,359,304	6.88%	\$30,000,000	0.61%
Bond Anticipation Notes	\$7,658,627	0.16%	\$0	0%
TOTAL DEBT	\$4,873,550,943	100.00%	\$157,640,000	3.23%

Source: California Debt & Investment Advisory Commission (CDIAC)

As the above data indicates, the number of variable rate credit enhancement opportunities has been limited during the past year. CalSTRS is available for business if the opportunity does arise.

TEACHER HOUSING IN CALIFORNIA

In the Spring of 2000, CalSTRS was approached by George K. Baum and Co. to determine whether CalSTRS had an interest in being part of a proposal in response to the City of San Jose Housing Department's request for proposal (RFP) to develop affordable housing for teachers in San Jose. The Ecumenical Association for Housing (EAH), which is a non-profit developer, was submitting a proposal based on the underwriting and advice provided by the investment banking firm George K. Baum & Co. CalSTRS joined the proposal as a credit enhancer on this transaction with the intent on working with another California financial institution. Upon completion of the selection process, the EAH proposal had the highest evaluation. Due to other circumstances, another developer was initially selected. However, in September 2000, the San Jose Housing Department has commenced discussions regarding another teacher housing project in San Jose. EAH is expected to receive the mandate to develop this housing project. CalSTRS would provide credit enhancement for this transaction.

George K. Baum & Co., EAH and CalSTRS have maintained a dialogue and have decided to continue making broader efforts at developing teacher housing in California. The proposed housing projects are based on developing "affordable housing" for teachers in communities which have high housing costs and utilizing tax-free financing structures to lower interest rate costs for the projects. EAH is currently "marketing" the program to a number of communities in California.

CONCLUSION

The opportunity set for CalSTRS to provide credit enhancement for K-12 schools and community colleges has been limited due to the small number of school bonds issued of significant dollar size where CalSTRS can provide enhancement for 25% of the transaction, and because of the limited number of variable rate COPs currently being issued. Staff continues to make financial advisors and underwriters aware of its capabilities in this area. Staff is currently working with EAH and George K. Baum & Company to develop opportunities in the area of "affordable housing" for teachers in communities which have high housing costs.